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October 21,2003

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OFFICE OF THE SECRETARY

Secretary
Securities and Exchange Commission
450 Fifth Street, N.W.
Washington, D.C. 20549-0609

RE: File No. SR-NASD-98-74

Dear Sir:

I am writing to strongly urge the Commission not to allow the NASD to amend its Rule 3110(F), as proposed by Release No. 34-48444, to include conflict of law clauses. **As** the material from my treatise on blue sky law indicates, such clauses are considered contrary to public policy in the states that have considered the issue. Further, virtually **all** states have anti-waiver provisions similar to Section 410(g) of the Uniform Securities Act (1956). Likewise, both the 1933 and 1934 Acts have similar anti-waiver provisions. This provision, again, **as** the attached materials indicate, has been interpreted by the courts which have considered the issue to prohibit the operation of such a clause *to* **deprive** the investor of his rights under the local state statute.

Further, most of the national brokerage houses will adopt a New York conflicts of law provision. **As** you well know, the Martin Act does not have **a** civil liability provision. The effect of allowing a New York choice of laws clause would be to deprive the investor of coverage under any state securities act. I doubt that the SEC would allow such waiver of coverage under the 1933 or 1934 **Acts.** Why should waiver of coverage under state law be allowed?

Further, as the attached materials indicate, the New **York** Martin **Act** is presently interpreted to prohibit some forms of common law recovery. Again, the investor, through the use of such clauses, could be **deprived** of virtually **any** remedy. Such position **was** specifically rejected in *Brenner v. Oppenheimer & Co.*, **44** P.3d 364 (Kan. *2002).*

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To allow any choice of law provision and especially a New York choice of laws clause will result in exactly the type of thing which the Supreme Court refused to allow in *Mastrobuono v. Shearson Lehman Hutton*, 514 U.S. 1212 (1995). No investor signing such clause would realize that he might be giving **up all** rights to recovery he had under the local state law or the law of the **place** where to broker was located, ***see*** *e.g., Barnebey v. E.F. Hutton & Co.*, **7** 15 F. **Supp.** 1512 (M.D.Fla. 1989), citing my treatise, by signing such clause.

With the state of the case law running against the validity of such clauses, the inclusion of such a clause would be a material misrepresentation under Section 410(a)(2) of the Uniform **Act.** Further, since this case law and anti-waiver provision are well known, such clause would be a knowingly violation of SEC Rule 10b-(5). The NASD ought not to be allowed to adopt a Rule which promotes or encourages fraud on the investors.

Sincerely,

Joseph C. Long
Professor Emeritus, University of Oklahoma
College of Law and
Author, Joseph C. Long, Blue Sky Law, Volumes 12 & 12A,
Thornson-West, 2003

Attachment

Securities Law Series

Blue Sky Law

by Joseph C. Long

VOLUME 12

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Release #3 (May, **2003)**

Finally it concluded that there was no violation of rights to "commercial free speech" under the first amendment?

VI. CHOICE OF LAWS CLAUSES

§ 4:44 Generally

It is increasingly common fur broker-dealers to include a choice of laws clause' in their retail customer agreements.[2] As to which state's law is chosen, the selection is usually governed by where the broker-

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App. 1975). Cf. Mon-Shore Management, Inc. v. Family Media, Inc., 584 F. Supp. 186 (S.D.N.Y. 1984), rehearing denied, 2 Bus. Franchise Guide (CCH) ¶ 8230 (S.D.N.Y. Sept. 5, 1984).

[34]The Commission's handling of this issue however, left something to be desired:

> Registration of securities under the Oklahoma Securities Act, when practically contemplated. involves a restriction only as to the manner in which securities may be offered or sold. The statutory regulation by registration does not seek to prevent or chill commercial speech in the transactions in securities except where the speech may involve such a misstatement or omission to constitute a fraud or deceit upon the Oklahoma investing public. The Commission is of the opinion that the Petitioners' offering is a form of public offering which the Oklahoma Securities Act's prior review and approval . . . and registration . . . provisions are fairly intended to be imposed upon.

In re Fundpack Inc., 1977 Mo. Sec. LEXIS 3 (Sept. 22, 1977) at 5. This issue was subsequently dealt with by the Supreme Court in Lowe v. SEC, 471 U.S. 181 (1985).

[Section 4:44]

'This section does not address the similar choice of forum clauses. Under a choice of forum clause, the investor agrees to bring suit only in the courts of a particular state. For example, in Robbins & Meyers v. J.M. Huber Co., 2002 WL 418206 (Tex. App. Mar. 19, 2002), the clause provided:

> Any suit, action or proceeding seeking to enforce any provision of, or based on any matter arising out of or in connection with, this Agreement or the transactions contemplated hereby, shall be brought in the State and Federal Courts in the State of New York. Id. at *1

These clauses are not in themselves choice of law clauses. As a result, the designated courts should apply the law of the place where the transaction took place. Because forum selection clauses do not limit the investors' substantive right, merely the place where those rights may be enforced. these clauses are much more frequently sustained than are choice of law clauses. See e.g, Robbins & Meyers v. J.M. Huber Co., 2002 WL 418206 (Tex. App. Mar. 19, 2002).

However, it is not uncommon for a forum selection clause to be coupled with a choice of laws clause. The coupling may be a factor in whether a court will. enforce the forum selection clause. America Online v. Superior Court, 90 Cal. App. 4th 1. 108 Cal. Rpte.2d 699 (2001).

These forum selection clauses also have been attacked on the basis that they do not apply to tort claims as opposed to contract claims. In Robbins & Meyers v. J.M. Huber Co., 2002 WL 418206 (Tex. App. Mar. 19, 2002), held that a broadly drawn clause, such as the quoted language above, covered both contracts and torts. However, more narrowly drawn clauses have been held not to cover tort actions, See e.g., Busse v. Pacific Cattle Feeding Fund #1, Ltd., 896 S.W.2d 807 at 813 (Tex. App. 1995), writ denied.

[2]These clauses often appear in two separate places in the agreement. As a general term of the agreement, there is often a provision which states that "the agreement and its enforcement will be governed by the law of X." Then, in the arbitration provi-

dealer is incorporated or has its main office. Since most of the major broker-dealers are headquartered in New York, New York law is the most common law selected.

The rationale usually given fur the inclusion of such clauses is a desire by the broker-dealer to have all its agreements and transactions governed by a single state's laws rather than the laws of the multiple jurisdictions where the various clients are located at the time of offer or sale. As has been seen above, the securities acts do not present a traditional conflict of laws problem.[3] As the acts are structured, the laws of two or more states will often apply to the same transaction.[4] Thus, if the registered representative is located at the broker-dealer's national headquarters in New York and makes an offer from New York to a customer in Oklahoma City, both the laws of New York[5] and Oklahoma[6] will apply to the transaction. However, if the registered representative is located in Dallas, Texas and makes the same offer to the Oklahoma City customer, then the laws of Texas and Oklahoma will apply, but the law of New York would not.[7]

While the desire to have all its transactions covered by the law of a single state is desirable from the broker-dealer's standpoint, a choice of laws clause has the intended or unintended effect of depriving the customer of his rights under one or more securities acts triggered by the transaction. The selection of New York as the controlling law may

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sion itself, there is often a provision stating: "The arbitration under this clause shall be governed by the law of X without regard to the choice of law rules of X."

Sometimes, however, the two parts are combined in a single agreement as in the following clause:

> This agreement, its enforcement and the relationship between the Client and the Firm shall be governed by the laws of the State of New York, including the arbitration provisions contained herein, without giving effect to the choice of law or conflict of laws provisions thereof....

[3]See § 4.3. Lintz v. Carey Manor. Ltd., 613 F.Supp. 543, 549 (W.D.Va. 1985).

[4]See generally, § 4:1. See generally. Lintz v. Carey Manor, Ltd., 613 F.Supp. 543, 549 (W.D.Va. 1985), and McClard. "The Applicability of Local Securities Acts to Multi-State Securities Transactions,'' 20 U.Rich. L. Rev. 139 (1985).

[5]See § 4:24.

[6]See § 4:10.

[7]In such case, there is a serious question whether a New York choice of laws clause would be enforceable. Restatement(Second) of Conflict of Laws '187(1969) generally recognizes the rights of the parties to select the law to govern their transaction. However, Section 187(a) establishes a limitation upon the power of selection. The state chosen must have a substantial relationship to the parties and the transaction. In the trade posed in the text, clearly New York has no connection to the transaction because it took place in Texas and Oklahoma. The only relationship between the parties is that the broker-dealer has its headquarters in New York. The NASD apparently thinks that the broker-dealer being located or headquartered in New York is sufficient. SeeNASD Notice to Members 95-85, 1995 WL 1712413 (Oct. 1995) and NASD Notice to Members 95-16, 1995 WL 1712330 (Mas. 1995). The author does not. Rest.(2d) Conflict of Laws '187, comment f appears to support the Author's position.

have an even more drastic effect to investor recovery. As will be seen in the next section, the New York blue sky state, the Martin Act,[8] has been interpreted by some courts to deprive the investment customer of any rights under New York law short of common law fraud.

These choice of laws clauses should not be enforced. They are generally in violation of the public policy of the state or states in which the transaction takes place. Further, such provisions are contrary to the anti-waiver provision of Section 410(g) of the Uniform Securities Act.

§ 4:45 —Customer's rights of recovery

The best way to determine the effect of New York choice of laws clause is to compare the rights and remedies of an investor under the Uniform Securities Act and common law of most states with the rights an investor would enjoy under New York law,

§ 4:46 — —Investor remedies under the Uniform Act[1] and Common Law

The following discussion is based upon the transaction taking place wholly or partially in a local Uniform Act jurisdiction. As outlined above, in such a situation, under Sections 414(a) and (c) of the Uniform Act, the local Uniform Act will attach to the transaction.[2]

§ 4:47 — — —Non-Registration of securities professionals

Section 201 of the Uniform Act requires the local registration of both the broker-dealer and the agent or registered representative handling the transaction. If either is not registered, the investor may set aside any or all transactions under Section 410(a)(1).

The operative facts for liability under this Section are that the broker-dealer or the registered representative was not registered locally and that the transaction took place at least partially in the local jurisdiction. There is no requirement that the seller, the broker-dealer, or the registered representative know that the securities professionals need to be registered.

If the broker-dealer has a local office and the registered representative is located in that office, there is a strong probability that both these professionals will be registered, and there is no cause of action

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[8] N.Y. Gen. Bus. Law Art. 23-A.

[Section 4:46]

[1] These rights and remedies are more fully discussed in Ch 9.

[2] See generally § 4:10 and 4:23. Under the same sections, if the offer is directed out of a state, then the law of that state will also attach. Therefore, if the offer to sell is directed from New York, New York law will attach in addition to the local law where the investor is located at the time of offer or sale. Likewise, if the investor directs an offer to buy into New York, New York law may or may not also attach under Sections 414(a) and (d).

under Section 410(a)(1). **However, if** the agent **or** registered representative is calling from an office outside the state, often the agent or registered representative will not be registered locally.[1] Likewise, many small or regional broker-dealers will not be registered outside **of** their home *state* or normal market area.[2]

It should be easy to determine whether there has been a registration violation. The local securities agency will provide a ***certificate*** of non-registration[3] that can be introduced to establish this fact. The states in which both a broker-dealer and its registered representatives are licensed in appears on the Central Record Depository ("CRD") report on the firm *or* individual.

Further, some broker-dealers, both introducing and clearing, now subscribe *to* outside services that **report** on **a** daily basis any trade where the registered representative is not registered in the local state **of** sale. Clearing brokers have the address where the confirmation slip is to be sent. They can easily check to ***see*** if the registered representative is licensed in that state **before** they complete the trade and send the confirmation.

§ 4:48 ———Non-Registration of securities

Section **301** of the Uniform Act requires that all securities which *are* offered *or* sold **in** the local state be registered or exempt,[1] or not be subject to state regulation because of federal pre-emption.[2] ***As*** in the case of non-registration of the securities professional, failure to register **a** security, if not exempt or pre-empted, results in civil liability under Section 410(a)(1) of the Uniform **Act.** The liability for unregistered securities is similar to that for non-registration of ***a*** securities professional. The operative facts for liability are that the securities were sold in the local jurisdiction and that they were unregistered. There is no requirement that the seller, the broker-dealer, or the registered representative know that the securities need to be registered.

It is easy to establish whether the securities were registered by checking with the local securities agency. It can **furnish** the investor a certificate of nun-registration that may be introduced to establish that

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[Section 4:47]

[1]For **example, a** registered representative of Merrill Lynch located in the Dallas office **calls an** investor client in Ardmore, Oklahoma. Merrill Lynch, as **a** national firm, will. **be** registered *in* Oklahoma, but **the** registered **representative** may not **be.**

[2]In such **case,** the registered representatives, of course, *are* also not registered.

[3]Unif. Sec. **Act,** '414(d). ***See*** generally, § 9:44.

[Section 4:48]

[1]See **Section** 402(a) **of the** Uniform **Act for the various securities and Section** 402(b) **for transaction exemptions.** *See* **generally, Ch *6* and *7*.**

[2]See **Securities Act of** 1933, § 18(b), 15 U.S.C.A. § 77(r)(b) **(as amended** 1996). *See* generally, §§ 5:18-5:26.

fact in a court or arbitration.

Most brokerage transactions involve either secondary sales of securities or private placement offerings. Under Section 301, secondary transactions are subject to the registration, exemption, or pre-emption requirement just as primary issuer transactions are. Many secondary trades, however, will be exempt or pre-empted.

Section 402(a) outlines the various securities exemptions, while 402(b) contains the transactional exemptions. There are four major exemptions which are often used in connection with secondary brokerage transactions. They are the exchange-listed exemption;[3] the manual exemption;[4] the unsolicited offer;[5] and the isolated non-issuer transaction exemption.[6]

In 1996, Congress passed the National Securities Market Improvement Act ("NSMIA") which pre-empted the states from requiring certain securities known as "covered securities"[7] to be registered or exempt.[8] NSMIA, however, did not restrict in any way the anti-fraud jurisdiction of the states.[9]

The most often used category of "covered securities" are securities

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[3]Unif Sec.Act § 402(a)(8). This exemption covers securities listed on the New York, American, and Mid-West Stock Exchanges and any other exchanges designated by the local state legislature. This designating authority is often delegated to the local securities administrator. As a result, the exchanges recognized vary widely from state-to-state.

This exemption has been partially pre-empted by Sections 18(b)(1)(A)-(C) of the Securities Act of 1933, 15 U.S.C.A. §§ 77r(b)(1)(A)-(C) (as amended 1996), which makes certain exchange-listed securities "covered securities". See generally, § 5:19-5:21. The coverage, however, is different between the exemption and the pre-emption. For example, Section 402(a)(8) covers the Mid-West Stock Exchange, which is not covered by Section 18(b)(1). On the other hand, Section 18(b)(1)(C) covers the first tier of the NASDAQ, the National Market System, not specifically covered by most state Section 402(a)(8) exemptions. Section 18(b)(1)(c) gives the SEC the authority, under certain stated conditions, to add securities traded on additional regional exchanges. The SEC has not yet exercised this power. Under state law, there are no conditions for the adding of additional exchanges, and the states have widely accepted many regional exchanges. *See* Table, 1 Blue Sky L. Rep. (CCH) ¶ 6401 (2001).

[4]Unif. Sec. Act § 402(b)(2)(A). See Table, I Blue Sky L. Rep. (CCH) ¶ 6301 (2002) for a state-by-state listing of manuals accepted. State regulation of securities covered by the Manual exemption have not been pre-empted. See generally, §§ 7:2-7:9.

[5]Unif. Sec. Act § 402(b)(3). The administrator can, and often does, require that a broker get and preserve fur a specified time a customer acknowledgment that the transaction is, in fact, unsolicited. The administrator may require this acknowledgment on a specific form. If the administrator has exercised this power and the broker cannot produce the signed form, no exemption exists. *See* generally, §§ 7:10-7:12.

[6]Unif. Sec. Act § 402(b)(1). Section 401(h) defines non-issuer to mean "not directly or indirectly for the benefit of the issuer."

[7]See generally, §§ 5:18-5:23.

[8]See generally, §§ 5:1-5:23.

[9]See generally, § 5:15.

traded on the New York and American Stock Exchanges and the **top tier of NASDAQ, the National Market System.**[10] **It is important to note that this pre-emption does not apply to the NASD Small Cap listing and the NASD bulletin board.**

Also, for some unknown reason, Congress pre-empted regulation of private placement securities under Rule 506 of Regulation D.[11] **Again, it is extremely important to recognize that the pre-emption does not extend to securities exempt at the federal level by Section 4(2) of the Securities Act of 1933.**[12]

Whether a security is pre-empted or exempt is an affirmative defense which the broker must claim and establish? A claim of exemption should definitely be taken with a grain of salt as the broker often cannot establish the exemption.

For example, the listings in the manual often do not meet the standards required by the statute.[14] Likewise, many less-than-ethical brokers will stamp all purchase tickets as being "unsolicited" when testimony of the client will establish that the sales were, in fact, solicited. Finally, many issuers will claim that their private placements qualify for Rule 506 when they know from the beginning that they cannot sustain the exemption because there are too many non-accredited investors or the non-accredited investors are not sophisticated. In this latter case, a state law registration violation can be established by discrediting pre-emption under Rule 506.

§ 4:49 ———Material omissions and misrepresentations

There is also liability under Section 410(a)(2) for any material misrepresentations or omissions made in connection with the sale of

[10] As noted above, the SEC has authority to add additional exchanges to the pre-emption list, if they meet certain standards. Presently, the SEC has not acted to add additional exchanges. See generally, § 5:22.

[11] 17 C.F.R. §§ 230.501-230.508. Congress did not pre-empt securities sold under either Rule 504 or 505. These securities continue to require registration or exemption at the state level.

[12] Again, these Section 4(2) securities must be registered or exempt at the state level.

[13] Unif. Sec. Act § 402(d) provides: "In any proceedings under this act, the burden of proving an exemption or an exception from a definition is upon the person claiming it."

[14] Unif. Sec. Act § 402(b)(2)(A), requiring the names of the issuer's officers and directors, a balance sheet of the issuer as of a date within eighteen months, and a profit and loss statement for either the fiscal year preceding that date or the most recent fiscal year of operations. Often Initial Public Offerings of start-up companies listed in a manual immediately upon issuance will not qualify. Likewise, the information may allow a stock to qualify at the time the manual entry was issued, but at the time of sale, the information is out of date. In such case, no exemption is available. *See* generally, §§ 7:2-7:9.

securities' in the local state. In most states, Section 101 of the Uniform Act, which reads similar to SEC Rule 10b-(5), does **not** result in civil liability.[2] It is strictly an enforcement section to be used by the administrator and in criminal cases. *As a* result, there is no civil liability **for employing any** device, scheme, or artifice to defraud; or engaging in any act, practice, or course of business that operates or would operate as **a** fraud or deceit upon any person.

Obviously there can be many different material omissions or misrepresentations.[3] Some of the more important in broker cases *are* failure *to* disclose non-registration of the securities professionals or the securities,[4] prior criminal activity whether or not a criminal conviction has resulted,[5] **prior** injunctions or sanctions,[6] and **pending** civil cases, investigations and stop orders.[7]

§ 4:50 — —Common law remedies

If the local securities act **applies** to a transaction, the local common law will also apply. In most states this means that there will be causes of action for fraud, intentional misrepresentation, negligent misrepresentation, negligence, breach of fiduciary duty, and breach of contract. In addition in some states, there may be a cause of action under the state deceptive trade practices act.[1]

[Section 4:49]

[1]This includes all material misrepresentations and omissions whether made by the registered representative, broker, issuer, or some third **party.** The person sought *to* be held liable is given an affirmative defense that he or she did not **know** or in the exercise of reasonable care could not have found out about the misrepresentation or omission. Thus, the broker and registered representative are potentially liable for the misrepresentations and omissions of others.

[2]Gilbert Family Partnership v. Nido Corp., 679 F.Supp. 679 (E.D. Mich. 1988); Hammerman v. Peacock, 607 F.Supp. 911 (D.C. 1985).

[3]See generally, Litigation and Practice Under Rule 10b-5 § **61.04** for a hundred-page list, with case citations, of various things that have been alleged *to* **be** material omissions and misrepresentation.

[4]See § 10:58. Failure to disclose that securities were not registered or exempt at the **federal level** is **a** material omission under ***the*** state act.

[5]See § 10:55. The SEC in its disclosure guidelines takes the position that criminal convictions over **five** years do not **have** to **be** disclosed. However, the federal courts have taken **the** position that **such** guidelines *are* a minimum standard for disclosure and that SEC **Rule** 10b-5 will require disclosure after **five** years. § 10:49. The states have generally taken **a** similar position *that* disclosure must be made after five **years.**

[6]See § 10:52. ***See*** **the previous** note for **a** discussion of **the five** year **cut-off by** the SEC

[7]See § 10:60.

[Section 4:50]

[1]*See* e.g., **Tex.** Civ. Stat. Art. **27.01.**

§ 4:51 ——Remedies under New York securities law

The Martin Act is the New York Blue Sky Law.[1] For a number of reasons, the Martin Act differs substantially from most other state securities acts. The Martin Act, with certain exceptions not relevant here, does not require the registration of securities.[2] It does, however, require the registration of brokers and registered representatives.

The Martin Act is an early blue sky statute, and is with most of these early statutes, it includes no provision imposing civil liability. As a result, the Martin Act was, and still is, enforced only by civil enforcement actions by the New York Attorney General or by criminal prosecution. Therefore, in those limited cases where the securities required registration and were not, or where the broker or registered representative was not registered in New York,[3] the client investor would have no civil cause of action under the Martin Act,

Section 352-c of the Martin Act contains anti-fraud provisions similar to SEC Rule 10b-(5)[4] and Section 101 of the Uniform Securities Act. While, as noted above, the Martin Act has no express civil liability provision, the lower New York courts for many years implied a cause of action similar to that under SEC Rule 10b-(5).[5] However, in 1987, in *CPC Int'l Inc. v. McKesson Corp.*,[6] the New York Court of Appeals overruled the lower courts and held that there is no implied civil cause of action for violation of Section 352-c.[7]

As a result of this analysis, it is clear that client-investors have no

[Section 4:51]

[1]N.Y. Gen. Bus. Law, *Art.* 23-A, § *352-c* et seq. (McKinney 1996).

[2]As the court said in Brenner v. Oppenheimer & Co., Inc., 44 P.3d 364 (Kan. 2002): "[T]he Martin Act fails to impose strict liability €or the sale of unregistered securities."

[3]This is unlikely if the broker and registered representative are located in New York. However, some of the major brokerage houses use New York choice of laws provisions in client agreements where a registered representative serves the client located in a local office in another state. In such case, the local registered representative might not be registered in New York. However, under the Uniform Act, since the transaction is not considered a New York transaction, see Unif. Sec. Act § § 414(a) and (c), the local registered representative would not have to be registered in New York. As a result, there would be no actionable violation for failure to register in New York.

[4]In fact, Rule 10b-(5) was modeled on this provision.

[5]There is one major difference. None of the operative parts of Section 352-c has ever been held to require proof of scienter, merely negligence. Therefore, in those states that make a violation of Section 101 of the Uniform Act civilly actionable, it can be argued that scienter is not required for any of the operative clauses. This contrasts with the federal approach where Section 17(a)(1) and SEC Rule 10b-(5)(a) have been held to require proof of scienter.

[6]CPC Intern. Inc. v. McKesson Corp., *70* N.Y.2d 268, 519 N.Y.S.2d 804, 514 N.E.2d 116, Blue Sky L. Rep. (CCH) ¶ *12641*, Fed. Sec. L. Rep. (CCH) ¶ 93419 (1987).

[7]The court said:

civil causes of action for registration or anti-fraud violations under the Martin Act. If a broker is allowed to insert a New York choice of laws clause, the net effect will be to strip the client-investor of his rights and remedies under the local state statute. Instead, the client-investor must look to the Martin Act where he has no civil remedy. Thus, by the use of a New York choice of laws clause if allowed, the brokers avoid any state securities liability.

§ 4:52 ——New York common law

If taking away rights under the local blue sky statute is bad, a New York choice of laws clause is even worse because it also deprives the client-investor the right to sue on most common law actions. New York common law, like that of most states, recognizes claims for breach of fiduciary duty, negligent misrepresentation, negligence, and breach of contract. However, the New York State[1] and Federal[2] Courts have interpreted the Martin Act to pre-empt such claims involving securities. The New York courts have reasoned that to allow these claims in the securities fraud context "would effectively permit a private action under the Martin Act, which would be, inconsistent with the Attorney-General's exclusive enforcement powers thereunder."[3] As a result, the lower federal courts have held that common law claims for breach of duty may not be brought.[4] Likewise, the

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General Business Law § 352-c prohibits various fraudulent and deceitful practices in the distribution, exchange, sale and purchase of securities. In all other states, except me, the Legislature has expressly recognized a private civil action for violation of the corresponding provision. Under the Martin Act, however, no private action has been expressly authorized. A majority of this court now holds that there is no cause of action impliedly created under section 352-c. [Footnote omitted.]

CPC Intern. Inc. v. McKesson Corp., 70 N.Y.2d 268, at 275-276, 519 N.Y.S.2d 804, at 806, 514 N.E.2d 116, Blue Sky L. Rep. (CCH) ¶ 72641, Fed. Sec. L. Rep. (CCH) ¶ 93419 (1987)

[Section 4:52]

[1] Rego Park Gardens Owners, Inc v. Rego Park Gardens Assoc., 191 A.D.2d 621, 595 N.Y.S.2d 492 (2d Dep't. 1993); Horn v. 440 E. 57th Co., 151 A.D.2d 112, 547 N.Y. S.2d 1 (1st Dep't 1989).

[2] Castellano v. Young & Rubicam, Inc., 257 F.3d 171, 17 I.E.R. Cas (BNA) 1673, Fed. Sec. L. Rep. (CCH) ¶ 91477 (2d Cir. 2001); Granite Partners, L.P. v. Bear Stearns & Co., Inc., 17 F.Supp.2d 275, 41 Fed. R. Serv. 3d 1345, 36 U.C.C. Rep. Serv.2d 1238 (S.D.N.Y. 1998).

[3] Eagle Tenants Corp. v. Fishbein, 182 A.D.2d 610,582 N.Y.S.2d 218 (1992), quoted with approval in Castellano v. Young & Rubicam, Inc., 257 F.3d 171, 17 I.E.R. Cas (BNA) 1673, Fed. Sec. L. Rep. (CCH) ¶ 91477 (2d Cir. 2001)

[4] See e.g., Castellano v. Young & Rubicam, Inc., 257 F.3d 171, 17 I.E.R. Cas (BNA) 1673, Fed. Sec. L. Rep. (CCH) ¶ 91477 (2d Cir. 2001); Gabriel Capital, L.P. v. Natwest Fin., Inc., 137 F.Supp.2d 251, 266-267, Fed. Sec. L. Rep. (CCH) ¶ 91277 (S.D.N.Y. 2000); Bibeault v. Advanced Health Corp., Fed, Sec. L. Rep. (CCH) ¶ 90487, 1999 WL 301691 at *10 (S.D.N.Y. May 12, 1999); Independent Order of

lower federal courts have dismissed claims for both negligence' and negligent misrepresentation.' Only common law claims for fraud survived. The rationale for allowing common law fraud claims to go forward is that Martin Act does not require the proof of scienter while common law fraud in New York does.[7] Therefore, because of this additional element not found under the Martin Act, a common law fraud claim does not impinge upon the Attorney-General's authority under the Act.'

In conclusion, if a New York choice of laws clause is honored, not only will the client-investor be stripped of his causes of action under the local state securities statute, but also of any common law claims except common law fraud. This clearly should be against public policy.

§ 4:53 —Interpretation of Martin Act may be changing

After the initial rash of decisions barring common law causes of action based upon their pre-emption by the Martin Act, both the New York and federal courts are beginning to re-evaluate this position. The Second Circuit in *Suez Equity Investors, L.P. v. Toronto-Dominion Bank'* did not decide the pre-emption issue but indicated that it considered the issue an open question. It said:

> The New York Court of Appeals has not yet addressed this issue, and the lower court cases ... do not explore the issue with the level of depth that would justify a ruling by us in the *first* instance. ... We are not immediately persuaded that the Court of Appeals would follow [the] lead [of these lower court decisions].[2]

At about the same time, the Fourth Department of the Appellate

Foresters v. Donaldson, Lufkin & Jenrette, Inc., 919 F.Supp. 149, 153 (S.D.N.Y. 1996).

[5]See e.g., Gabriel Capital, L.P. v. Natwest Fin., Inc., 137 F.Supp.2d 251, 266-267, Fed. Sec. L. Rep. (CCH) ¶ 91277 (S.D.N.Y. *2000)*

[6]Spirit Partners, L.P. v. audiohighway.com, *2000* WL 685022 at *6 (S.D.N.Y. May 25, 2000); Bibeault v. Advanced Health Corp., Fed. Sec. L. Rep. (CCH) ¶ 90487, 1999 WL 301691 at *10 (S.D.N.Y. May 12, 1999); Independent Order of Foresters v. Donaldson, Lufkin & Jenrette, Inc., 919 F.Supp. 149, 153 (S.D.N.Y. 1996).

[7]Lehman Bros. Commercial Corp. v. Minmetals Int'l Non-Ferrous Metals Trading Co., 179 F.Supp.2d 159 (S.D.N.Y. 2001).

[8]Eagle Tenants Corp. v. Fishbein, 182 A.D.2d 610, 619, 582 N.Y.S.2d 218, 219 (1992). See also, Castellano v. Young & Rubicam, Inc., 257 F.3d 171, 189-190, 17 T.E.R. Cas (BNA) 1673, Fed. Sec. L. Rep. (CCH) ¶ 91477 (2d Cir. 2001)

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'Suez Equity Investors, L.P. v. Toronto-Dominion Bank, 250 F.3d *87* (2d Cir. 2001). But see, Castellano v. Young & Rubicam, Inc., 257 F.3d 171, 189-190, 17 I.E.R. Cas (BNA) 1673, Fed. Sec. L. Rep. (CCH) ¶ *91471* (2d Cir. 2001), decided by another Panel of *the* Second Circuit a month after *Suez*, which, without mentioning *Suez*, adopts *the* pre-emption theory without discussion.

[2]Suez Equity Investors, L.P. v. Toronto-Dominion Bank, 250 F.3d 87 at 104 (2d Cir. 2001)

Division, in *Scalp & Blade, Inc. v. Advest, Inc.*,[3] disagreed with the pre-emption conclusions of the First and Second Departments. It held:

> Nothing in the Martin Act or in the Court of Appeals cases construing it, precludes a plaintiff from maintaining common-law causes of action based on such facts as might give the Attorney-General a basis for proceeding civilly or criminally against a defendant under the Martin Act.[4]

Finally, Judge Cote in *Cromer Finance Ltd. v. Berger*,[5] rejected the pre-emption argument. Echoing the language of *Suez Equity* and *Scalp & Blade*, Judge Cote wrote:

> [T]here is nothing in either the New York Court; of Appeals cases...or in the text of the Martin Act itself to indicate an intention to abrogate common law causes of action. ...In particular, there does not appear to be any basis in the Martin Act's provisions for a distinction between claims of fraud and claims for negligent misrepresentation, and both New York Court of Appeals decisions allowed plaintiffs' common law fraud claims to proceed. Accordingly, the plaintiffs' negligence claims are nut precluded by the Martin Act.[6]

Judge Cote then went on to predict that the Second Circuit would adopt the *Scalp & Blade* analysis.[7]

6 4:54 —Clauses are void

There are three arguments which suggest that these choice of laws clauses in securities agreements are void. First, the case law suggests that these clauses are void as against the public policy of the state where the investor was located at the time of either the offer or the sale.' Second, this conclusion is re-enforced under the Uniform Securities Act as Section 410(g) contains an anti-waiver provision. Courts

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[3]Scalp & Blade, Inc. v. Advest, Inc., 281 A.D.2d 882, 722 N.Y.S.2d 639 (4th Dep't 2001).

[4]Scalp & Blade, Inc. v. Advest, Inc., 281 A.D.2d 882, at 884 722 N.Y.S.2d 639, at 640 (4th Dep't 2001).

[5]Cromer Finance, Ltd. v. Berger, Fed. Sec. L. Rep. (CCH) ¶ 91550, 2001 WL 1112548 (S.D.N.Y. 2001). See also, In re Rickel & Assoc., Inc., 272 B.R. 74 (Bnkrcy, S.D.N.Y. 2002).

[6]Cromer Finance, Ltd. v. Berger, Fed. Sec. L. Rep. (CCH) ¶ 91550, 2001 WL 1112548 at *4 (S.D.N.Y. 2001)

[7]Cromer Finance, Ltd. v. Berger, Fed. Sec. L. Rep. (CCH) ¶ 91550, 2001 WL 1112548 at *4 N. 6 (S.D.N.Y. 2001)

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'Getter v. R.G. Dickinson & Co., 366 F.Supp. 559 (S.D. Iowa 1973); Boehnen v. Walston & Co., Inc., 358 F.Supp. 537, Blue Sky L. Rep. (CCH) ¶ 71098 (D.S.D. 1973); Hall v. Superior Court, 150 Cal. App.3d 411, 197 Cal.Rptr. 757, Blue Sky L. Rep. (CCH) ¶ 71929 (4th Dist.1983); Brenner v. Oppenheimer & Co., Inc., 44 P.3d 364 (Kan.Apr. 19, 2002); Ito Corp. v. Prescott, Inc., 83 Wash.App. 282,921 P.2d 566, Blue Sky L. Rep. (CCH) ¶ 74127 (Wash. Div. 11996) have held that this section voids choice of laws clauses.[2] Finally, an argument can be made that such clauses violate the NASD Rules of Fair Practice.

§ 4:55 ——Clauses void as against public policy

It is generally recognized that the courts will honor a choice of laws clause.[1] However, the power of the parties to select a particular state's laws to govern is not absolute.[2] The Restatement (Second), Conflict of Laws recognizes to two limitations on this power. First, the state whose law is selected must have a substantial relationship to the parties.[3] Second, the application of the law of the selected state may not be "contrary to a fundamental policy of a state which has a materially greater interest'?than the state selected.[4] In support of this position the Restatement states:

> Fulfillment of the parties' expectation is not the only value in contract law; regard must also be had for state interest and state regulation. The chosen law should not be applied without regard for the interests of the state which would be the state of the applicable law...in absence of an effective choice by the parties. ...Application of the chosen law will be refused...to protect a fundament policy of the state which...would be the otherwise applicable law....[5]

Some five cases[6] have considered the public policy issue in connec-

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[2]Hall v. Superior Court, 150 Cal. App.3d 411, 197 Cal.Rptr. 757, Blue Sky L. Rep. (CCH) ¶ 71929 (4th Dist.1983); Brenner v. Oppenheimer & Co., Inc., 44 P.3d 364 (Kan.Apr. 19, 2002). See also, Ito Corp. v. Prescott, Inc., 83 Wash.App. 282, 921 P.2d 566, Blue Sky L. Rep. (CCH) ¶ 74127 (Wash. Div. 11996) (decided on the basis of public policy, but Washington Act also has the anti-waiver provision).

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[1]See e.g., Brenner v. Oppenheimer & Co., Inc., 44 P.3d 364 (Kan.Apr. 19, 2002). Rest.(2d) Conflict of Laws § 187(1) (1969) states:

> The law of the state chosen by the parties to govern their contractual rights and duties will be applied if the particular issue is one which the parties could have resolved by an explicit provision in their agreement directed to that issue.

See also, Wehe v. Montgomery, 711 F.Supp. 1035, Fed, Sec. L. Rep. (CCH) ¶ 94527. (D.Ore. 1989)(court assumes without discussion that New York choice of law clause is valid).

[2]Rest. (2d) Conflict of Laws § 187(2)(1969).

[3]Rest. (2d) Conflict of Laws § 187(2)(a)(1969).

[4]Rest. (2d) Conflict of Laws § 187(2)(b)(1969). See also, State ex re. Geil v. Corcoran, 623 S.W.2d 557 (Mo. App. 1981).

[5]Rest. (2d) Conflict of Laws § 187, Comment g (1967). The comment makes clear that the reaching of a contrary result is not of itself a violation of a state's fundamental policy. But it is a factor to consider whether there is a conflict between the laws of two states, so that the court has to go through a conflict of laws analysis. Brenner v. Oppenheimer & Co., Inc., 44 P.3d 364 (Kan.Apr. 19, 2002)

[6]Getter v. R.G. Dickinson & Co., 366 F.Supp. 559 (S.D Iowa 1973); Boehnen v. Walston & Co., Inc., 358 F.Supp. 537, Blue Sky L. Rep. (CCH) ¶ 71098 (D.S.D. 1973);

tion with the state securities acts.[7] All have concluded that the public policy of the state where the investor was located at the time of either the offer or the sale as expressed in its securities act invalidates any choice of laws clause.

The trend here was established in *Boehnen v. Walston & Co., Inc.*[8] The facts of *Boehnen* are typical of most of these cases. Boehnen claimed the stocks purchased from Walston & Co.. were not registered in South Dakota, where he was located at the time of sale.[9] The broker's standard customer agreement provided that New York law should govern.[10] In rejecting the defendants' argument that New York law controlled, the court stated:

> [A]stipulation by which the parties select the law to govern the contact is valid and will be given effect only if it is not contrary to public policy generally, or to the public policy of the forum,..., or in violation of a statute of the forum enacted for the protection of its citizens...

Hall v. Superior Court, 150 Cal. App.3d 411, 197 Cal.Rptr. 757, Blue Sky L. Rep. (CCH) ¶ 71929 (4th Dist.1983); Brenner v. Oppenheimer & Co., Inc., 44 P.3d 364 (Kan.Apr. 19, 2002); Ito Corp. v. Prescott, Inc., 83 Wash.App. 282, 921 P.2d 566, Blue Sky L. Rep. (CCH) ¶ 74127 (Wash. Div. 11996)

[7]This may present a problem when the issue is presented to a federal rather than a state court. A federal court, when sitting in diversity of citizenship or exercising pendent jurisdiction over state law claims, must apply the conflict rules of the jurisdiction wherein the court sits. Klaxon Co. v. Stentor Electric Mfg., 313 U.S. 487, 61 S.Ct. 1020, 85 L.Ed. 1477, (1941); Shearson Lehman Bros., Inc. v. M&L Investments, 10 F.3d 1510, Fed. Sec. L. Rep. (CCH) ¶ 98050 (10th Cir. 1993). If, under the local conflicts rule, the state courts would determine which state had the primary interest in the transaction and apply that state's conflict rule and public policy as to when such rule could be voided, then the federal court should follow the lead of the state court. Shearson Lehman Bros., Inc. v. M&L Investments, 10 F.3d 1510, Fed. Sec. L. Rep. (CCH) ¶ 98050 (10th Cir. 1993). Thus, in *Shearson Bros.*, the court should have looked to Utah for its basic conflicts rule and not at Utah's substantive law as to whether a choice of laws clause would be voided. Utah's conflict rule indicated that law of the state with the greatest interest should control. Then the substantive law of that *state* would determine whether the choice of laws clause was valid.

The court in WTM, Inc. v. Henneck, 125 F.Supp.2d 864 (N.D. Ill. 2000), missed this two step process. It correctly held that it must follow the Illinois law. Rather than determining under the Illinois conflict rule which state's substantive law should apply, it incorrectly applied Illinois substantive law. It reached the obvious conclusion that it did not offend Illinois' public policy not to enforce the non-waiver provision of the Minnesota *Securities* Act. Assuming that Minnesota was the state with the meatest interest in the transaction, Minnesota law should have controlled whether the choice of laws clause would be recognized. The non-waiver provision in its securities act clearly established that such clause should not be enforced.

[8]Boehnen v. Walston & Co., Inc., 358 F.Supp. 537, Blue Sky L. Rep. (CCH) ¶ 71098 (D.S.D. 1973).

[9]It was also his state of residence.

[10]The agreement provided in part: "The provisions of this agreement shall in all respects be construed according to, and the rights and liabilities of the parties hereto shall in all respects be governed by, the laws of the State of New York."

The purpose of the South Dakota Blue Sky Laws is to protect the public." To permit the choice of law stipulation in question to control the determination of whether or not South Dakota law will apply, would be to provide an effective means of circumventing legislation designed to protect the citizens of South Dakota. This would clearly be against public policy.[12]

Shortly after *Boehnen*, the Iowa federal district court in *Getter v. R. G. Dickinson Co.*,[13] addressed the same issue under the Iowa statute. It concluded:

Ordinarily, choice of laws provisions in contracts are valid except where they are contrary to State public policy. In the present case, we have a protective statute for purchasers of securities in the State of Iowa. This Court concludes as a matter of law that under the circumstance of this cause of action that the plaintiffs did not waive the protection of the Iowa Securities Act.[14]

Most recently the Kansas court in *Benner v. Oppenheimer & Co., Inc.*,[15] the court invalidated a New York choice of laws clause as violating Kansas public policy. It said:

It seems clear to this court that a strong public policy in favor of rigid governmental regulation of the sale of securities and the protection of investors exists and has been thoroughly established in both statutory and case law.[16]

§ 4:56 — —Clauses void under Anti-Waiver provision

The public policy considerations outlined in the last section are made explicit in the Uniform Act by the inclusion of an anti-waver provision in Section 410(g). This Section reads:

Any condition, stipulation, or provision binding any person acquiring any security to waive compliance with any provision of this act or any rule or order hereunder is void.'

Curiously, few cases have sought to apply this anti-waiver provision

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[11] [Author's note] Citation omitted.

[12] Boehnen v. Walston & Co., Inc., 358 F.Supp. 537, at 540-541, Blue Sky L. Rep. (CCH) ¶ 71098 (D.S.D. 1913)

[13] Getter v. R.G. Dickinson & Co., 366 F.Supp. 559 (S.D. Iowa 1973). See also, Paracor Fin., Inc. v. Genral Electric Capital Corp., 96 F.3d 1151, Blue Sky L. Rep. (CCH) ¶ 74088, Fed. Sec. L. Rep. (CCH) ¶ 99315 (9th Cir. 1996).

[14] Getter v. R.G. Dickinson & Co., 366 F.Supp. 559, at 575 (S.D. Iowa 1973). See also, Hall v. Superior Court, 150 Cal. App.3d 411, 197 Cal.Rptr. 757, Blue Sky L. Rep. (CCH) ¶ 71929 (4th Dist.1983).

[15] Brenner v. Oppenheimer & Co., Inc., 44 P.3d 364 (Kan.Apr. 19, 2002)

[16] Brenner v. Oppenheimer & Co., Inc., 44 P.3d 364 (Kan.Apr. 19, 2002)

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'Emphasis added.

in addition to general public policy.[2] The leading case here is *Hall v. Superior Court*.[3] The court invalidated the choice of laws clause, saying:

> Because the choice of law provision in the ... agreement violates the Corporations Code and the public policy of this state, we hold enforcement of the choice of forum provision is unreasonable.[4]
>
> The court continued:
>
> California's policy is to protect the public from fraud and deception in securities transactions. The Corporate Securities Law of 1968 was enacted to effectuate this policy by regulating securities transactions in California and providing statutory remedies for violations of the Corporations Code, in addition to those available under common law. The cornerstone of the law is Section 25701, [the anti-waiver provision][5] ... [Under this provision], the parties may not waive or evade the application of California law to the transaction by private agreement.[6]
>
> Finally the court stated:
>
> California's policy to protect securities investors, without more, would probably justify denial of enforcement of the choice of forum provision, although a failure to do so might not constitute an abuse of discretion; but *Section 25701*, which renders void any provision purporting to waive or evade the Corporate Securities Law, removes that discretion and compels denial of enforcement.
>
> Similarly, we believe the right of a buyer of securities in California to have California law and its concomitant nuances apply to any future dispute arising out of the transaction is a "provision" within the meaning of *Section 25701* which cannot be waived or evaded by stipulation of the parties to a securities transaction. Consequently, we hold the choice of Nevada law provision in this agreement violates *Section 25701* and the public policy of this state and for that reason deny enforcement of the forum selection clause as unreasonable.[7]

This same analysis was used by the Washington court in *Ito Int'l*

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[2]Hall v. Superior Court, 150 Cal. App.3d 411, at 417, 197 Cal.Rptr. 757, at 761, Blue Sky L. Rep. (CCH) ¶ 71929 (4th Dist.1983); Brenner v. Oppenheimer & Co., Inc., 44 P.3d 364 (Kan.Apr. 19, 2002). See also, Ito Corp. v. Prescott, Inc., 83 Wash. App. 282, 921 P.2d 566, Blue Sky L. Rep. (CCH) ¶ 74127 (Wash. Div. 11996)(decided on the basis of public policy, but Washington Act also has the anti-waiver provision).

[3]Hall v. Superior Court, 150 Cal. App.3d 411, 197 Cal.Rptr. 757, Blue Sky L. Rep. (CCH) ¶ 71929 (4th Dist.1983).

[4]Hall v. Superior Court, 150 Cal. App.3d 411, at 413, 197 Cal.Rptr. 757, at 759, Blue Sky L. Rep. (CCH) ¶ 71929 (4th Dist.1983)

[5][Author's note.] *Section 25701* provides: "Any condition, stipulation or provision purporting to bind any person acquiring any security to waive compliance with any provision of this law ... is void.'"

[6]Hall v. Superior Court, 150 Cal. App.3d 411, at 417, 197 Cal.Rptr. 757, at 761, Blue *Sky* L. Rep. (CCH) ¶ 71929 (*4th* Dist.1983). *Footnotes* and citations omitted-I

[7]Hall v. Superior Court, 150 Cal. App.3d 411, at 418, 197 Cal.Rptr. 757, at 762, 763, Blue Sky L. Rep. (CCH) ¶ 71929 (4th Dist.1983). [Citation omitted.]

Corp. v. Prescott.[8] In *Ito,* the court said:

> The Washington State Securities Act] states that any provision binding a person acquiring a security to waive compliance with the statute is void. RCW 21.20.430(5). Washington courts will not implement a choice of law provision if it conflicts with a fundamental state policy or if the state has a materially greater interest than the other jurisdiction in the resolution of the issue. ...Here, the State has a strong interest in applying its securities act to a partnership involving several Washington defendants, Washington plaintiffs, and property located in Washington. Because the WSSA expressly invalidates provisions waiving compliance with the statute, we do not rely on the choice of law provision....[9]

§ 4:57 —Choice of laws clause may violate NASD Rules of Conduct

Finally, when arbitration is involved, a strong argument can be made that a New York choice of law clause violates NASD Rule of Conduct IM-3110(f)(4).[1] The SEC mandated in 1989 that all Self-Regulatory Organizations adopt rules prohibiting in plain language any contract provision that purports to limit customer claims or remedies arbitrators can utilize. Rule 3110(f)(4) currently reads in part:

> No agreement shall include any condition which limits or contradicts the rules of any self-regulatory organization or limits the ability of the arbitrators to make any award.[2]

In 1995, the NASD issued Notice to Members 95-16 which warned that the use of a New York choice of laws clause to prohibit the award of punitive damages would violate Rule 3110(f)(4). The NASD then warned that enforcement action would be taken against member firms that continued to use such clauses to prohibit punitive damages. The NASD then, in 1998, took action against Bear Stearns & Co., Merrill Lynch & Co, and Biltmore.[3]

While the focus of the NASD has been on the use of choice of law clauses to defeat the award of punitive damages, the NASD also recognizes that clauses can be used to deprive customers of causes of action they might otherwise enjoy under local law. In November of 1999, the NASD responding to criticism of Rule 3110(f)(4) proposed to amend

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[8]Ito Corp. v. Prescott, lac., 83 Wash.App. 282, 921 P.2d 566, Blue Sky L. Rep. (CCH) ¶ 7412'7 (Wash. Div. 11996)

[9]Ito Corp. v. Prescott, Inc., 83 Wash.App. 282. at 288-289, 921 P.2d 566, at 570, Blue Sky L. Rep. (CCH) ¶ 74127 (Wash. Div. 11996). The court went on to conduct a traditional choice of law analysis, concluding that Washington law would control-

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[1]This is old Rule 21(f)(4) of the NASD Rules of Fair Conduct.

[2]NASD Manual NASD Manual § IM-3110(f)(4)(2001).

[3]30 BNA SRL 1778 (Dec. 18, 1998).

the Rule.[4] In its statement of purpose for the rule change, it admitted that choice of laws clauses could be used to "limit the availability of certain remedies, such as punitive damages, or the ability of a customer to bring a claim."[5] The amendment was to clarify the existing rule.

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[4]SEC Release No. 42160, 1999 WL 1054611 (NASD Nov. 19, 1999). The proposed amendment of 3110(f)(4)(A) read:

> No predispute arbitration agreement shall include any candition that:
>
> (i) limits or contradicts the rules of any self-regulatory organization;
>
> (ii) limits the ability of a party to file any claim in arbitration;
>
> (iii) limits the ability of a party to file any claim in court permitted to be filed in court under the rules of the forums in which a claim may be filed under the agreement;
>
> (iv) limits the ability of arbitrators to make any award.

[5]SEC Release No. 42160, 1999 WL 1054611 at *5 (NASD Nov. 19, 1999)